No. 8994

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

. E. KLIPSTEIN,

Appellant,

vs.

ERBERT P. SEARS, Trustee in Bankruptcy of the Estate of Globe Drug Company, Inc.,

Appellee.

BRIEF FOR APPELLEE.

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STATEMENT OF THE CASE.

Appellee takes the liberty of setting forth his own statement of the case, and the facts involved, for the reason that certain statements made by appellant in his opening brief, or at least the conclusions based on them, appear to us to be inaccurate.

The complainant, as trustee of the estate of the bankrupt corporation, Globe Drug Company, Inc., seeks to recover from the defendants certain money wrongfully paid out by the bankrupt corporation to or for the personal benefit of the defendants while they were directors, officers, and stockholders of said

corporation. The following is a brief resume of t facts upon which the claim is based.

Globe Drug Company, Inc., was incorporated und the laws of California in 1920, with an authoriz capital stock of 25,000 shares of the par value $1.00 each, and with a Board of Directors consisti of three members. (Tr. pp. 52, 53.) On Decemb 31, 1927 the defendants were elected as directors at stockholders' meeting duly called and held. On t same day, the directors met and elected officers, t appellant Klipstein then being chosen as vice-pre dent.

On January 3, 1928 the defendants Stelzner a Klipstein executed to the Bank of America their pe sonal promissory note in the sum of $17,000.00. Th signed this note as joint makers. Stelzner, the pre dent of the corporation, used the proceeds of this lo to purchase stock of the corporation from certain oth stockholders. Almost contemporaneously with t completion of such purchase, on January 5, 19 9990 shares of such stock were issued to the appella Klipstein. (Tr. p. 55.)

From the date of the maturity of said note, April 1928, periodical payments were made on account the principal and interest thereof during a period over seven years. (Tr. pp. 39-42.) All these payme were made out of the corporation's own funds. (T p. 55.) They were made by corporate checks payab direct to the order of the bank, signed by Stelzner president. No consideration was ever received by for the corporation for such payments. (Tr. p. 56.)

Neither of the defendants has ever reimbursed the corporation for any of these payments. There is no showing that these payments were made out of surplus profits of the corporation, or that, at the time they were made, the corporation ever had any surplus profits. There are no records in the Minute Book given authorizing the payments.

On each and all of the dates when these payments were made, the corporation was indebted in an amount exceeding the amount of each payment. (Tr. pp. 50-51.)

There is an incidental element in the facts which, while having nothing to do with the extent of the recovery sought and awarded by the trial court, has an indirect bearing upon the position of the appellant here. On October 19, 1935, when the $17,000.00 note had been paid down to a balance of $4800.00, the corporation, at the instance and direction of its Board of Directors, and at a meeting at which the defendants were present and acting as such, executed its own promissory note directly to the bank for said sum of $4800.00 in payment of the balance then due on the $17,000.00 note. (Tr. pp. 55, 56.) The corporation received absolutely no consideration for the execution of this note. (Tr. p. 56.) Contemporaneously with its execution and delivery, Klipstein purchased the note from the bank, and immediately, on the same day, commenced an action in the Superior Court of Kern County, against the corporation, Globe Drug Company, Inc., for the recovery of $5364.00 claimed by Klipstein in his verified complaint to be due to him

from the defendant corporation. (Tr. p. 56.) $4800.
of this claim was represented by the $4800.00 no
The same attorneys who represented Klipstein in th
action were at the same time also attorneys for t
defendant corporation. (Tr. p. 62.) A default jud-
ment was suffered to be entered against the corpor-
tion in favor of Klipstein, for the sum of $5373.8
together with $177.00 costs. Pursuant to this jud-
ment all of the remaining property and assets of t
corporation were sold by the sheriff on execution s
for the sum of $1935.00. (Tr. p. 58.) From th
Klipstein, the judgment creditor, has withheld t
sum of $608.75. Subsequent to the filing of the i-
voluntary petition in bankruptcy as hereinafter r-
lated, said judgment creditor turned over the balan
to the trustee in bankruptcy.

On the petition of other creditors involuntary pr-
ceedings in bankruptcy were filed against the corpor-
tion on February 14, 1936, and it was adjudicated
bankrupt on March 6, 1936. On behalf of the ban-
rupt, Stelzner, its president, filed a schedule in ban-
ruptcy, showing debts of $11,043.87 and assets
$3985.63. Thus it appears that there is not enou
money or property in the bankrupt's estate with whi
to pay its creditors and the expenses of administratio

The question at issue in the case is whether the
two defendants, directors, officers, and shareholders
the bankrupt corporation, are liable to the trustee
bankruptcy for the funds of the corporation thus m-
appropriated by them, to an extent sufficient to satis
all just and proper claims and reasonable allowanc

ad expenses in the bankruptcy proceeding. The court b ow has determined by its decree that they are so lible, and has limited that liability to the maximum etent of $4500.00, calculated by the court to be sufficient to pay all such claims, allowances, and expenses. he defendant Stelzner has prosecuted no appeal, and a to him the decree is final. His co-defendant, Klipsin, the appellant here, has appealed, claiming the dcree is erroneous.

APPELLEE'S THEORY OF THE CASE.

This is a plenary suit in which the trustee of the bnkrupt seeks to recover for the estate property now llonging to it and necessary to pay the claims of editors.

There are various sections in the former Bankrptcy Act conferring upon the trustee the right to ecover such property. These are Sections 47, 67, and 7. For the purposes of this discussion we can disgard Section 67, which has to do with the special and culiar right of the trustee to avoid preferences. In te instant case it is not necessary for the trustee to sert a preference or to rely upon Section 67, and he es not do so.

Since the amendment of 1910 to the Bankruptcy t, the trustee's title to such property is three-fold, mely, he takes, first, the title of the bankrupt; cond, the title of creditors; and third, the peculiar ght to set aside preferences. The second title, that

which he derives from creditors, is itself three-fo
First, the right to recover property fraudulently he
second, the right to avoid transactions which are v
as to existing creditors; and third, the right of a
creditor under state law, armed with process, whet
or not, in fact, there be such creditor actually in
istence. (Remington, Vol. 4, Sec. 1508.) Here
trustee has all of these rights, except the right
avoid a preference, which, as stated above, he does
assert.

As appears from the allegations in the bill (Tr.
5-10), the defendants have a dual responsibility to
trustee. In the first place, they occupy the positi
of recipients of the benefits of the wrongful transf
by the bankrupt corporation of its property. In
second place, they are not only the recipients of th
benefits, but are also the agents and representati
of the corporation through whom it acted in disposi
of the property. And inasmuch as the bankrupt is
corporation and the defendants were its directo
officers, and stockholders, there come into play
those legal rules and principles under which such c
porate agents and representatives are held liable,
only under statutory law, but the common law as w
for wrongfully disposing of, misappropriating, a
wasting the corporation's property to their own be
fit.

There is one general fallacy in the position taken
the appellant Klipstein in the arguments advanced
his opening brief. He would seek to have his liabil
measured exclusively by a particular statute, which

esigned to impose a liability upon corporate directors or specific wrongs done during their administration office. Appellant forgets or disregards the common w, and all the other general legal principles recogzed not only in California but in all the states, which ave always imposed upon corporate directors and fficers liability for malfeasance or misfeasance in ffice, or for participating in or benefiting from a isappropriation of the corporation's assets. Indeed, proper regard for this aspect of the law pertinent this case reveals a complete answer to almost the ntire brief of the appellant. We will attempt to make his clear in our argument hereinafter set forth.

ARGUMENT.

KLIPSTEIN WAS A DIRECTOR, OFFICER, AND STOCKHOLDER OF THE CORPORATION DURING ALL OF THE TRANSACTIONS INVOLVED.

Appellant seeks to escape his liability upon the spetous contention that he was never a director, officer, r stockholder of the corporation, and even that Globe Drug Company, Inc., was never organized as a corporation.

In his original verified answer there was a clear dmission of the allegation of the bill that the corporation was duly organized and existing under and by irtue of the laws of the State of California. (Tr. p. 1.) The same admission appears in Stelzner's answer. (Tr. p. 16.) Klipstein, at the trial, filed an mendment to his answer in which, in the face of his

sworn admission in his original answer, he sought
deny the organization of the corporation. (Tr. p. 21
Of course the evidence clearly shows the due organiz
tion of the corporation as such, with all the requisi
incidents, such as an authorized capital stock, a Boa
of Directors, and officers, all functioning as suc
(Tr. p. 53.)

The corporate records further show that on Decer
ber 31, 1927, at a meeting of directors at which h
was present and acting, Klipstein was elected as th
vice-president of the corporation, and that on Januar
4, 1928, at a directors' meeting at which he was prese
and acting, he was elected secretary of the corporatio
This corporate record was attested by Klipstein's ow
signature. (Tr. p. 53.)

A great deal of argument is indulged in by Klip
stein in which, in the face of these records, he seek
to disavow his capacity as a director, now directing
collateral attack against his qualification as such. W
believe such a discussion is wholly unnecessary an
futile, for various reasons. It must be remembere
that Klipstein was continuously a director from an
after December 31, 1927, when he was elected. Ther
is no evidence that he ever resigned or that any su
cessor to him was ever elected. He acted as a directo
at the meeting of October 19, 1935. (Tr. p. 53.) H
denies that he was a *de jure* director, because he wa
not a stockholder. The evidence shows that stock wa
issued to him on December 21, 1927, prior to his ele
tion, and again on January 5, 1928. He accepted an

receipted for this stock. (Tr. p. 55.) He never transferred it. He now claims that this stock was void because it was issued without the permit of the Corporation Commissioner; that, therefore, he lacked the legal qualification for a *de jure* director. Even if such a contention were important here, this appellant would not be permitted to seek refuge behind it to the prejudice of a third party. Moreover, the acts complained of here took place in and after the year 1933, at which time it was no longer necessary for directors of California corporations to be stockholders in order to qualify. (Section 305, Civil Code.) If there were any doubt of his *de jure* capacity, certainly there could be none that he was, and acted as, a director *de facto*. (6A Cal. Jur. p. 1068.)

Klipstein does not, and cannot, deny that he was an officer, the secretary, of the corporation, during the times involved. He was elected as such on January 4, 1928. We find him acting as such on October 1, 1935. We must assume that he continuously occupied such office during all such interval of time and thereafter, because there is no record or other proof of a successor to him ever being elected.

There is ample evidence in the record to sustain the court's finding that at all of the times involved Klipstein was a director, officer, and stockholder of the corporation.

KLIPSTEIN PERSONALLY BENEFITED FROM THE MISAPPR PRIATION OF THE CORPORATION'S ASSETS.

Klipstein says that he received no benefit from th payments made by the corporation to the bank on h and Stelzner's personal note. He makes such co tentions as these: that he was but an accommodatio maker; that he received no part of the considerati for the note; that the bank regarded him as only surety on the note, etc. These are such contentio as he might be expected to make if he were bein sued on the note.

But he is not here being sued on the note; he being sued for misappropriating and wasting the co poration's assets, and the fact that he personall benefited from the disposition of those assets link him closer to the wrong and accentuates his liabilit It is conceded by Klipstein that he was liable on th note. It is immaterial whether his liability was tha of joint maker, guarantor, surety, or otherwise. H recognized his liability, because when payments be came delinquent the bank called upon him and he mad them. (Tr. p. 61.) It is apparent that every tim the corporation made a payment on the note, i satisfied *pro tanto* Klipstein's liability on it. Conse quently, he was in the position of a corporate di rector and officer, using the corporation's funds t satisfy his own personal obligation, and appropriating and consenting to the appropriation of, the corporat assets to his own use. Clearly it was a misappropria tion, because the corporation never owed anything t Klipstein and received no consideration for thus pay ing out its funds. All this is to say nothing of th

ıcidental fact that the corporation's funds were used
idirectly to purchase outstanding stock, 9990 shares
f which went to Klipstein upon its purchase, which
i but an additional indication that Klipstein was a
neficiary of the misappropriation of the corporate
ssets. He says in his brief that he was not beneficially
iterested in this stock; Stelzner admitted in his an-
ver that the stock was put in Klipstein's name as
curity. (Tr. p. 16.) But the stock records set forth
o such qualifying entries; they show Klipstein to
e the absolute owner thereof. (Tr. p. 55.) In either
ıse he was benefited.

THE NATURE OF KLIPSTEIN'S LIABILITY.

In considering the nature of Klipstein's liability
ı this case, it is necessary at all times to bear in
ind the position which he occupies. Not only was
e a director and officer of the corporation, and as
ıch an actor in the disposition of the corporate
ssets, but also he was the recipient of the benefits
sulting therefrom. Moreover, this complainant-
ustee in bankruptcy not only represents the cred-
ors of the bankrupt estate, with the incidental rights
nferred by the Bankruptcy Act, but he also repre-
nts the bankrupt corporation and stands in its
oes, a corporation which was under the complete
omination and control of the defendants. He has
ıcceeded to any and all rights that the bankrupt
ıd against any and all parties for the recovery of
ıy of the corporation's property that might have

been wrongfully dissipated, wasted, given away, misappropriated. Also, we must not forget that th appellant in the eyes of the law occupied a fiducia relationship to the bankrupt corporation, in line wi which he was at all times bound to exercise the hig est degree of good faith and honesty in connecti with its affairs.

We are reminded by counsel, unnecessarily, course, that the liability of the appellant depends up the law of the State of California. They studious draw attention to a recent decision of the Unit States Supreme Court in *Erie Railroad Company Tompkins* which, by overruling *Swift v. Tyson,* pr duced a marked change in the conception of the la governing federal courts. But however interesti counsel's point may be in the abstract, there is n necessity for a consideration or discussion of it her

The trustee quite readily concedes that the appe lant's liability must be determined in accordance wi legal principles recognized in the State of Californi He denies, however, that these legal principles mu be confined within the narrow limits contended for b the appellant. We maintain that there is here n only ample statutory enactments declaring appellant liability, but also that in California certain rules an principles outside the written law have long bee enforced, under which the appellant must be hel answerable for the wrongs complained of here.

DEFENDANTS' POSITION AS CORPORATE AGENTS.

Let us consider appellant's position as a director ad officer, in other words, an agent, of the corporaon. A director is charged with the highest degree good faith. Under the circumstances involved in is case, he is a trustee for the corporation and as ach occupies a fiduciary relationship. He must not nite his personal and representative character in the me transaction, nor must he use his official position benefit himself individually. (*Dean v. Shingle,* 08 Cal. at p. 658.)

These duties, and the obligations arising therefrom, hve always been imposed upon corporate directors ad officers, and they exist today, regardless of whether not they are the subject of legislative enactment. California these principles have always been fundaental in the corporation law of that state.

> "Directors are also trustees for the stockholders and indirectly for the creditors. They have always been held responsible as trustees in their management of the property and affairs of the corporation. Like trustees, they must not deal with the subject of the trust for their own advantage, * * *.
>
> "Directors and officers of corporations, as well as trustees, have always been held responsible for loss resulting from misappropriations of the trust property made by them or with their consent. The character of the misappropriations for which the officers who made them can be held responsible to the corporation has been settled in many cases. The liability has existed

ever since there have been courts of equity and corporations or trustees."

Winchester v. Howard, 136 Cal. at pp. 442, 443.

In California statutory enactments have never changed this liability. The legislature has, it is true, taken cognizance of situations in which a director may not be a direct actor in the wrong and, therefore individually culpable. Under these particular conditions they have sought to create directors' liability for certain specific acts, and in doing so they have prescribed certain conditions which must exist for the imposition of such liability. However, it is inconceivable that California, or any other state, could ever pass a law affecting the liability of a corporate director to make restitution to injured parties of moneys and assets of the corporation that he has withdrawn and appropriated to his individual use and benefit. As said in *Southern Cal. Home Builders v. Young,* 45 Cal. App. at pp. 690, 691:

"It has always been presumed that directors have knowledge of the business of the corporations it is their duty to manage and control. Before the adoption of any of the statutes in terms making directors liable, among other things, for declaring dividends out of capital, it was recognized both in the courts of common law and in the courts of equity that directors as trustees were liable for acts of malfeasance or misfeasance by which the capital of the corporation might be improperly depleted. * * * In the growth of corporate intervention in ordinary business affairs,

> it is inconceivable that by the adoption of these statutes the legislatures of a number of states intended to lessen the responsibility of directors by declaring them liable for specific breaches of trust, which by their mention in the statute might have the effect of relieving the directors from civil liability for other breaches not mentioned."

The fallacy of appellant's position, emphasized throughout his brief, lies in his effort to persuade this court that the measure of his liability in this case lies entirely within the terms and provisions of Section 363 of the Civil Code of California, as amended in 1933. He studiously calls attention to the limitations prescribed in that statute and contends that the evidence in this case falls short of fulfilling the required conditions of the liability there declared. It is true that in his bill complainant set forth a second cause of action in which was contained a conclusionary allegation that the misappropriation and withdrawal of corporate funds by the defendants was in violation of Section 363, C. C., and its predecessor, Civil Code Section 309. However, consistent with the rule of pleading in equity cases, the bill contains a concise statement of the facts pertinent to the wrongs complained of and the liability sought to be imposed, and the existence of the liability is none the less affected whether it be by virtue of any particular statute, or in accordance with recognized legal principles aside from any statute.

Appellant in his brief devotes much of his argument to some of the conditions necessary for the imposition of the liability prescribed by Section 363, C. C. He complains, among other things, that there is no showing in the evidence that Klipstein assumed to act as a director, that he was present when the withdrawals were authorized, that he ever assented to such withdrawals, and of the exact amount of the debts which existed at the time of each of the numerous withdrawals over the period of more than seven years. If we were seeking to establish here only the particular liability declared by Civil Code Section 363, if this were not a case of downright misappropriation of the corporation's assets, if Klipstein knew nothing of the nature and purpose of the withdrawals, or if the payments to the bank in no way benefited him individually and personally, there might then be some reason for a careful consideration of the existence here of these particular statutory conditions. But it is plain to be seen that Klipstein does not occupy a position to which these conditions are necessarily pertinent. Of course it is apparent on the face of the situation that even the conditions prescribed by the code section do in fact exist. As we have demonstrated above, Klipstein was a director and acted as such; while no actual resolutions were adopted authorizing the payments to the bank, nevertheless Klipstein must have known that the payments were being made to the bank and credited upon his note obligation; obviously he consented to the making of the payments by accepting the benefit thereof; he actively participated in the passag

of the resolution of the Board of Directors authorizing the execution of the $4800.00 note in satisfaction of the balance due on his note to the bank; every time a withdrawal was made, the corporation was indebted in excess of such withdrawal. Therefore, even if it were necessary in this case for the trustee to rely solely upon the liability declared by the particular statute, his showing is amply sufficient to justify the imposition of it. It must not be forgotten that the defendants failed to make any showing at the trial justifying the withdrawals. Stelzner alleged in his answer that the withdrawals were made from surplus profits. (Tr. p. 17.) But no attempt to prove this was made, nor was any attempt made to show that such existing indebtedness had ever been paid.

Klipstein tries to make us believe that he was at all times so remote from the situation as to excuse him from the liability. He insists that his own case is to be differentiated from that of his cohort, Stelzner, who admits his liability. He now says that he had no interest in the corporation's drug business. But he concedes that he helped his brother-in-law, Stelzner, to borrow the money from the bank to purchase outstanding stock, some of which he received. He disavows his directorship, although he consented to his election, accepted the offices of director and secretary, and actively participated in regular corporate proceedings. He now denies he was a stockholder, although he took and received a substantial portion of the corporation's stock which he helped his brother-in-law to buy for $17,000.00, without at that time, or

until now, raising any question as to the regularity of such stock. He now says that he can never get it out of his head that there was no corporate entity and that the Globe Drug Company, Inc., consisted of an individual, his brother-in-law; all in the face of the fact that he was an experienced businessman engaged in the title business, lent himself to dealings in the corporation's stock, and participated in proceedings appropriate to the conduct of corporate business. In addition to all this we find him commencing an action against Globe Drug Company, Inc., a corporation, not against Stelzner, individually, for money which he swore was due to him from the defendant corporation, not from Stelzner individually. He now says that he has never derived any gain or benefit whatsoever from his relationship with the corporation, and that in fact he is the loser. But as a result of the loan which he helped his brother-in-law make, he acquired 9990 shares of the corporation's stock, practically a two-fifths' interest in the corporation's business.

It is interesting to reflect for a moment upon what the situation might have been if this corporation had prospered, had made money, and been able to pay all its debts as they matured. Then, of course, we would not be here before this court, and there would then be no necessity for Klipstein to urge these various fantastic contentions. But the corporation failed and is now defunct. It is in bankruptcy, with numerous unpaid creditors. Its stock is valueless, and perhaps in that sense Klipstein has suffered a loss. But the corporation is defunct and in bankruptcy because it used

its assets to buy up stock for Klipstein's and Stelzner's account. If that had not been done, there would have been no bankruptcy and no unpaid creditors. Courts are constantly faced with situations where men become connected with corporate business ventures, either actively or inactively, under which they and their associates at the time give little thought to the possible consequences in case the venture fails. They willingly assume the probability of gain, but they avoid the thought of the possibility of losses. When failure occurs they seek to disavow any connection with the enterprise and urge the courts to relieve them from responsibilities which they should have comprehended and appreciated in the beginning. There could be little safety in commercial transactions if the law permitted, through the use of the corporate fiction, such a violation of creditors' rights.

THE DEFENDANTS ARE CHARGEABLE WITH FRAUD.

It is contended by appellant's counsel that there is no showing of either actual or constructive fraud on the part of the defendants. In our opinion it is wholly unnecessary to indulge in an extended discussion of this point. In so far as it is necessary, the evidentiary facts are sufficient upon which to base the finding of the court that the flagrant misappropriation of the corporation funds, continuously over a long period of time, constituted fraud.

These defendants here are concededly guilty of taking the corporation's funds and appropriating them to

their own use. The law says that this is a fraud. The courts declare it to be constructively fraudulent as to the creditors of the corporation. (14a *C. J.*, pp. 180, 188.) Any violation of a duty growing out of a fiduciary relationship is constructively fraudulent.

Under all these circumstances it was incumbent upon the defendants to show to the court, if they could, the bona fides of their acts.

> "Moreover, whether or not these directors were trustees for creditors (see cases, 14a C. Jur. 169), their status was so far fiduciary in respect to creditors that they are subject to the rule that these corporate transfers challenged, the burden is defendant's to vindicate them. See Geddes v. Mining Co., 254 U. S. 599, 41 Sup. Ct. 209, 65 L. Ed. 425, and cases therein cited.
>
> "That is to say, defendant must prove that the transfers were in good faith, fair, reasonable, and for adequate consideration or at a time when, excluding them, the corporation was solvent and not contemplating insolvency; in brief, defendant must prove the transfers are not fraudulent in respect to corporate creditors."
>
> *Oliver v. Brennan,* 292 Fed. at p. 201 (affirmed, 299 Fed. 106, C. C. A. 9th).

Such showing of constructive fraud was sufficient to make out a *prima facie* case of actual intent to defraud creditors. Consequently, in this respect also, it was incumbent upon the defendants to go forward with proof of the lack of such intent, and it was the function of the trial court to determine whether or not they had sufficiently complied with this legal re-

quirement. (*Hemenway v. Thaxter,* 150 Cal. 737; *Hanscome-James-Winship v. Ainger,* 71 Cal. App. 735; *Wilson v. Robinson,* 83 Fed. (2d) 397.) Certainly it cannot be said that under the circumstances here, and still bearing in mind the nature of the wrongful acts of these corporate directors and officers, it was plaintiff's duty to show the existence of all the requirements of the fraudulent conveyance statutes at each time a misappropriation of funds was made; in other words, at the time the defendants caused each payment to be made on their note with the bank. Incidentally, the trustee testified: "The records of the Globe Drug Company, when they came into my hands, were very incomplete, very difficult to examine or ascertain anything from; we had quite a bit of trouble." (Tr. p. 65.)

THE LIABILITY OF THE DEFENDANTS RUNS TO ALL THE CREDITORS OF THE BANKRUPT.

Appellant's counsel urge that the liability here sought to be enforced runs only to the benefit of creditors existing at the time of each wrongful act, at the same time calling attention to the 1933 amendment to section 363 of the Civil Code of California. But here again they seek to confine our attention to a specific statutory declaration of directors' liability outside the scope of and beyond the fundamental common law liability here involved. The fact that a statute gives to creditors a direct remedy against directors for wrongs they commit, certainly does not affect the common law remedy of the corporation to redress those

wrongs, or the rights of a trustee in bankruptcy to recover corporate property unlawfully disposed of by directors. (See *In re Dalton Electric Co.,* 7 Fed. Supp. 465.) Under this theory of the liability of defendants, it was only necessary for plaintiff to show that at least one creditor existed at the times of the misappropriations. These directors were just as much liable, according to these legal principles, whether the corporation was insolvent or not at each and all of the times of the withdrawals. (See *Lytle v. Andrews,* 34 Fed. (2d) 252.)

Likewise, according to this theory of the liability, all of the creditors represented by the trustee, who have claims against the bankrupt estate, have a definite right to participate in any recovery from the defendants. The courts of California recognize this rule.

> "The argument that the trustee cannot bring this action on behalf of creditors whose claims were not in existence at the time of the fraud is also without merit. Subsequent creditors are entitled to recover (Sherman v. S. K. D. Oil Co. 185 Cal. 534 (197 Pac. 799); Clark v. Tompkins 205 Cal. 373 (270 Pac. 946)), and the trustee is a party authorized to sue on their behalf. (Schroeter v. Abbott, 185 Cal. 146 (196 Pac. 39); Dean v. Shingle, 198 Cal. 653 (46 A. L. R. 1156, 246 Pac. 1094).)"
>
> *Kahle v. Stepens,* 214 Cal. at p. 93.

See also:

In re Wright Motor Company, 299 Fed. 106;
Hanson v. Cal. Bank, 17 Cal. App. (2d) 80.

THE RULES AND PRINCIPLES DECLARED IN IN RE WRIGHT MOTOR COMPANY ARE APPLICABLE TO THE INSTANT CASE.

Appellant's counsel seek to draw distinctions between the instant case and *In re Wright Motor Company,* 299 Fed. 106, C. C. A. 9th, 1924, decided in this circuit, and followed here by the lower court. They say that there is a difference in the facts involved; but we are willing to submit, without an extended discussion, that fundamentally and substantially there is a striking similarity in all those essential facts which are necessary to justify the interposition of a court of equity to redress the wrong, the character of which is the same in both cases. Counsel concede the absolute integrity of the decision in the *Wright Motor Company* case, but they say that its effect has been destroyed by *Erie Ry. Co. v. Tompkins,* and also that certain statutory liability touched upon in the opinion has been changed by subsequent legislative amendment. This, obviously, is mere sophistry. Although, in his opinion affirming the decision of the lower court, Circuit Judge Hunt did discuss certain statutory provisions in the laws of California, it is plain that he recognized that the liability there enforced existed regardless of these statutes, and that independent of them the misappropriation of the corporation's properties and assets by the defendant there was a fraud upon the creditors of the corporation. In this connection he said:

> "The rulings were based, not merely upon a liability imposed by statute, but upon the ground that it is a fraud upon the creditors of a corpora-

> tion to distribute corporate property to stockholders without providing for the payment of debts of the corporation. Sanger v. Upton, 91 U. S. 56, 23 L. Ed. 220; Schulte v. Boulevard Gardens Land Co., 164 Cal. 467, 129 Pac. 582, 44 L. R. A. (N. S.) 156, Ann. Cas. 1914B, 1013."

These principles are still fundamental in the law of the State of California and have never been changed either by the legislature or the courts.

It is plain to be seen that the *Erie Ry. Co.* case has had absolutely no effect whatever upon the *Wright Motor Company* case, for the very obvious reason that this court in that case strictly followed legal rules and principles embodied in the basic law of the State of California. There is nothing in the opinion of the court indicating otherwise, or that there was in the mind of the court any idea of departing from the California law and granting relief in accordance with any legal conception recognized exclusively in the federal courts.

THE DECREE OF THE LOWER COURT IS PROPER AND IN ACCORDANCE WITH THE REQUIREMENTS OF EQUITY PROCEDURE.

In formulating its decree the lower court followed the practice observed in the *Wright Motor Company* case. In effect, the court ordered the defendants to make restitution, to a limited extent, of the fund which they took from the corporation and appropriated to their own use. The extent of the recovery was limited to a maximum of $4500.00, which is some

what below the aggregate amount of misappropriations during the three-year period prior to the adjudication of bankruptcy. As the lower court pointed out in its opinion, there was no necessity for an accounting of the sums misappropriated, for the reason that proof of the amounts thereof was undisputed. It took judicial notice of the creditors' claims proved in the bankruptcy proceedings, as it had a right to do (*Hall v. Glenn,* 247 Fed. 997; C. C. A. 9th), and concluded that the amount of the recovery awarded was adequate for all purposes.

Appellant objects that under such decree his liability is uncertain. The same objection was made and overruled in the *Wright Motor Company* case. The decree protects the rights and interests of the appellant by providing that, if the amount necessary to pay and satisfy all just and proper claims and reasonable allowances and expenses in the bankruptcy proceedings is less than the maximum award of $4500.00, the excess shall be returned to the defendants.

Appellant intimates that a special master should have been appointed for the purposes mentioned in the decree. The bankruptcy court is an arm of the federal district court, and the Referee in Bankruptcy is the special referee of that court in all matters having to do with the administration of bankrupts' estates. Appellant further complains that he is not represented in the bankruptcy proceeding and would have no standing to contest the propriety of any claims or expense allowances. This is an inconsiderate statement. He has, as the decree provides, an interest in the res

to be administered, and therefore he is a party in interest within the purview of section 57 of the Bankruptcy Act. Also, paragraph 6 of General Order XXI affords to appellant the right of which he thinks he is deprived. The defendants are directors and stockholders of the bankrupt corporation which, under said General Order, could cause the re-examination of any claim against the estate.

CONCLUSION.

Stripped of all the superfluities discussed by appellant in his brief, it would appear that this case is after all, quite simple. There is little, if any, dispute about the essential facts. The money of the bankrupt corporation was taken and paid on the personal obligations of the defendants. It has never been paid back. There could scarcely be a clearer case of the wrongful misappropriation of a corporation's property by its directors and officers.

The defendants at the trial offered no defense worthy of the name. Here the appellant seeks to justify himself by an argumentative discussion of points of law more or less unrelated to the principal issue involved and the main question to be determined. In the conclusion to their brief counsel make the suggestion that this court's opinion on this appeal will constitute the first interpretation by any court of the meaning, validity, and effect of section 363 of the California Civil Code. However interesting a legalistic

discussion of this legislative enactment would be, in our opinion the necessity for it does not exist here. In other words, whether the lower court has committed error in making its decree, does not depend in any vital respect on the meaning and effect of this code section. The appellee might just as well offer the suggestion that this court consider the effect of section 366 of the California Civil Code, holding directors and officers liable for making loans of a corporation's money or property, which liability, under the circumstances involved in this case, would seem to exist here. We might even go farther and invite attention to section 560 of the California Penal Code, in effect declaring it to be a crime for a corporate director to concur in a wrongful distribution of corporate assets, which liability would also appear to exist here.

Since the defendants are unable to offer any justification for their misdeeds, and since their malfeasance and plain breach of duty has always been condemned under any standard of morals and good conscience, it would seem to be unnecessary in determining their liability to look any farther than to those fundamental legal principles which, from time immemorial, have always been applied to just such situations as the one involved here. As the California courts of last resort have said, no legislative act has ever changed these legal principles in that state.

The lower court has determined that these defendants must make restitution of the money which they took from the corporation for their own use instead

of using it to pay its just debts. We submit that any other determination would be in violation of the true legal principles applicable here, and that, therefore, the decree of the lower court should be affirmed.

Dated, San Francisco,
January 11, 1939.

Respectfully submitted,
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